

**A Work Project, presented as part of the requirements for the Award of a Master's  
Degree in Finance from Nova School of Business and Economics from Universidade  
Nova de Lisboa**

# **Merger between Zon Multimedia and Sonaecom: Revisiting the consolidation Scenario**

**Henrique Almeida, 347**

**Supervision of:  
Professor Paulo Soares Pinho**

**6<sup>th</sup> January 2012**

## **Revisiting the merger and acquisition scenario**

Several changes in the Portuguese telecommunication sector led Rodrigo Costa, CEO of Zon Multimedia (ZON), to revisit a possible merger with Sonaecom (SNC). This subject has been discussed since ZON spun off from Portugal Telecom (PT), in November 2007. In fact, ZON profits are being affected by the current Portuguese crisis, the increasingly intense competition of PT and the incapability of providing a complete and reliable package integrating all the services (mobile telephone, fixed telephone, mobile broadband, fixed broadband and pay-TV), demanded by customers.

Despite clear strategic benefits the merger would bring to both companies, its tie-up was never concluded, mainly due to the opposition of ZON's shareholders who are simultaneously in PT's shareholders structure. Rodrigo Costa knows that there are clear synergies that could be exploited if this tie-up goes forward and he believes that those synergies would create value for both companies' shareholders.

Firstly, this tie-up could bring significant reduction in expenses, as well as a small increase in revenues. Furthermore, the size of the resulting company will be considerably larger and will attain 3.5 million mobile subscribers and 3 million in the fixed segment. On the other hand, Portugal Telecom launched Meo, in May 2009, as its commercial telecommunications services. Since then, and through an aggressive marketing strategy, Meo has shown exponential penetration in the market, leading to an increasingly strong competition. PT has benefited from being one of the largest Portuguese companies, which allowed enormous investments in advertisement, in order to attract customers. Nowadays, this is what differentiates the companies in this sector, as there is not so much price

competition. It is also the reason why a customer prefers one company's services and over another.

Sonaecom has been interested in this possible merger for a long time and Paulo Azevedo, CEO of Sonae SGPS, Sonaecom's major shareholder, has already shown publicly interest in the merger. Furthermore, there were recent changes in ZON's shareholder structure and it is predictable that other changes will occur soon. Thus, Rodrigo Costa considers that this could be the right time to revisit the possible merger of these two companies.

### **Brief Description of the Companies**

#### **Zon Multimedia<sup>1</sup>**

PT Multimedia, now Zon Multimedia, was a fully owned subsidiary of Portugal Telecom. An unsuccessful attempt by Sonaecom to acquire PT, in 2007, via a hostile takeover, led to PT Multimedia to spin off from Portugal Telecom. This take-off was not achieved mainly due to the opposition of PT shareholders. Afterwards, the market regulator (ANACOM), forced the spin-off of PT's subsidiary, since it had almost a monopolistic position in the Portuguese telecommunication sector.

Thus, Zon Multimedia, ex- PT Multimedia, was born from the structural reorganization of Portugal Telecom in November 2007. Since then, the company has been led by Rodrigo Costa, a former member of PT's board of directors. Following the spin off, Rodrigo Costa tried to emphasize that ZON did not belong to Portugal Telecom any longer. Thus, some of his primary decisions had as main goal clarifying employees and customers that ZON was a

---

<sup>1</sup> See Appendix 1 for Financial information and shareholder structure

new company, with a new culture. On the first day after the spin-off, Rodrigo Costa ordered to remove PT's logo from its headquarters, becoming the company to be called only as Multimedia for some months.

Nowadays, its operations could be divided into three different business units: the pay-TV market, telecommunications and entertainment even though nowadays its core business is the *tripleplay* market, which integrates pay-TV, fixed telephone and fixed broadband in one service. Operating in a highly competitive market and with fast development in new technologies, ZON made huge investments in order to develop new technologies and improve its own infrastructure. It is the market leader in the pay-TV business and it is still growing in the fixed broadband and fixed telephone. ZON is also able to provide mobile services (telephone and broadband) complementing its offers in the telecommunication sector. In terms of fixed offers, ZON is extending increasingly in the corporate sector.

In 2010, ZON started its first activity in the international market, in Angola, with a partnership with Ms. Isabel dos Santos. Recently, in June 2011, it has also started operating in Mozambique. However, it is extremely exposed to the Portuguese market and, by now, internationalization is not a solution to solve the problems caused by the difficult Portuguese economic situation and changes in demand.

One of ZON's main goals is to keep the leading position in the pay-TV market and in innovative services on digital offers, with gradually more sophisticated and attractive features and with more contents in High Definition (HD). In January 2011, the company launched a new platform, called Iris, and in October released 10 new HD channels achieving the leadership position in the HD market, with a total of 36 channels. At the same

time, it has been developing its customer service and reinforcing its coverage in the private market. On the other hand, in the cinema market, it has been investing in new technologies, such as digital and 3D cinemas, making ZON an international reference in this sector.

In 2010, ZON invested 248.1 million euros, 28% of its total revenues, continuing the investment process started in 2008. However, it is expected that from 2011 onwards there will be significant reductions on CAPEX.

Despite high levels of investment in the economic year of 2010, the group approved to pay dividends of 0.16 euros per share, which totaled 49.5 million euros. *Caixa Geral de Depósitos* is its biggest shareholder (10.88% of total capital) followed by *Kento Holding* (10%), *Banco Português de Investimento* (7.56%), *Telefonica* (5.46%), *Banco Espírito Santo* (5%), *Joaquim Oliveira* (4.84%), *Joe Berardo* (4.34%) and *Ongoing* (3.29%).

ZON's shareholders position was never clear regarding this possible merger. One can think that ZON's position is mainly due to the fact that its biggest shareholders are the same ones as those of PT, its major competitor. Therefore, it is not easy to predict which position would be more valuable for them. On the one hand, the exploitation of possible synergies between ZON and Sonaecom can increase competition with PT, which could lead to the decrease of their profits. On the other hand, keeping PT without any severe competition means not getting the possible benefits from tie-up of ZON and Sonaecom.

At present, it is predictable that some changes in shareholder structure will occur in the short to medium run and it is believed that the rational position of these new shareholders would be in favor of the merger. To start with, it is believed that *Kento Holdings*, which bought a 10% stake at ZON, in the end of 2009, is favorable to a possible merger. Also,

*Cofina*, one of the biggest shareholders against the tie-up, exited from ZON's capital structure. And finally, according to the IMF and European Authorities, *Caixa Geral de Depósitos* will have to divest on the non-core subsidiaries. And, since it has an important position in PT's shareholder structure, probably it will quit from ZON as it makes no sense to keep its position on both companies.

### **Sonaecom (SNC)<sup>2</sup>**

Sonaecom, led by Ângelo Paupério, is the Sonae Telecommunications holding. It was founded in 1994 and its core business is the telecommunication sector, through Optimus, covering both corporate and residential customers in Portugal. Furthermore, it also operates in the Software and Systems Information (SSI) and in Media sectors.

Sonaecom has been disclosing increasing profitability and guarantees that it is progressing in all business units, reinforcing its market share in the mobile segments offering innovative solutions. At the same time, it has achieved a new level of efficient and rigorous management of costs and investments. Even in the current difficult economic situation Sonaecom has encouraging prospects for the future, assuming that it is prepared to face the challenges and grab the opportunities that might appear in the market.

Its main goal is to be the best group in the Portuguese integrated telecommunication sector, with a strategy that goes through continuous investments in a network of advanced technology offering the best fixed and mobile services. Thus, in 2010, its activities were reorganized, devoting special attention to mobile and fixed services.

---

<sup>2</sup> See Appendix 2 for Financial information and shareholder structure

Optimus, led by Miguel Almeida, represents 90% of Sonaecom business volume. It concentrates the communication activity and covers all the market segments – residential, private, mass business, corporate, and wholesale – and all business areas – mobile and fixed, aiming to provide integrated solutions in voice, broadband, TV and data, through mobile or fixed terminals.

The mobile market is the core of Optimus, but the fixed market is assuming an increasingly important and complementary role. In the latter, the strategy is mainly concentrated in the corporate segment, while the residential segment is becoming more and more residual. Consequently, in 2010, Optimus stopped investing in its own fiber networking and looked for alternatives that would allow them to keep expanding. This new strategy included a partnership with Vodafone, which allowed Optimus to use Vodafone fiber optic network to duplicate its coverage in Oporto and in Lisbon.

On the other hand, in the Software and Systems Information (SSI) sector which aggregates numerous companies renowned in the IT sector, Sonaecom is investing in the consolidation of WeDo, assuring the development in areas as fraud prevention and business assurance. In the media sector, the group will keep its daily newspaper, *Público* both online and paper versions, as well as *Miau.pt*, the online auction website.

Sonaecom is listed in the PSI-20 having a constant shareholder structure over the past decade. *Sonae SGPS* is the major shareholder, holding more than 53% of the total shares, around 21% of the shares are free float, followed by *France Telecom* (20%) and *Banco Comercial Português* (3.41%).

### **Portugal Telecom (PTC) <sup>3</sup>**

The growth of Portugal Telecom is one of the factors that most worries Rodrigo Costa. With PT Multimedia's spin-off, Portugal Telecom launched a new brand, called Meo, which would compete with ZON in the pay-TV market, as well as in the *tripleplay* and *multipleplay* offers.

Firstly, we have to keep in mind that PT is one of the biggest Portuguese companies. Its investment capacity, in infrastructures and in marketing, is far higher than its competitors. One of the most relevant consequences of Portugal Telecom's size is the fact that a few years ago, PT had not had any offer in the pay-TV market, and only in three years it has achieved more than 30% of market share in this business unit. This allowed it to drive gains in the fixed broadband and reverse the negative trend in the fixed telephone.

In 2010, there was a fierce price competition between ZON and Meo, which led to consecutive decreases in the price for telecom services. Nowadays, the factors that drive customers to choose operator are the perception that each customer has from the companies. For instance, Meo has a clear advantage relatively to the other operators, since its communication strategy has been a great success. Notwithstanding, one cannot compare the expenses incurred by Meo in advertisement with the remaining operators.

Now, Meo has a clear goal of keeping its market leadership or achieve it in the business units that it does not at present. Through continuous investments in fixed and mobile infrastructures, PT intends to keep exploiting the synergies between them in order to provide even better integrated services.

---

<sup>3</sup> Appendix 3 for Key Performance Indicators (KPI)



## **Macroeconomic Outlook**

With the current economic situation in Portugal, the changes in demand by customers and the exponential growth of Portugal Telecom, Rodrigo Costa considers that both companies should revisit the M&A scenario.

Initially, the Portuguese macroeconomic outlook has been affecting negatively the stock market performance. Both companies have been penalized since the beginning of 2008: Sonaecom performance stands at -46.6%, ZON at -76.1% and the main Portuguese Index (PSI-20) at -49%. In September 2009, rumors of a possible merger of these two companies led companies to gain more than 3%, which could be interpreted that the merger could be well accepted by the market in general.<sup>4</sup>

Another concern resulting from the actual economic situation is the changes in credit markets, specifically costs and also availability of credit. These changes not only affect companies when they are seeking for new credits, but also for their shareholders, which have been using their shares as collateral in credit lines. Nowadays, these shareholders have to use additional guarantees as collateral since the shares have lost a significant value.

Regarding the Portuguese economy, the greatest concern of Rodrigo Costa is the fact that his company is tremendously exposed to the Portuguese market. Thus, it is crucial to find new methods to keep and strengthen its positions in the market. Domestic consumption is expected to decrease in 2012, and it will have a negative impact in ZON's revenues. This puts ZON under pressure, forcing them to seek different paths to bear their operating performance.

---

<sup>4</sup> See appendix 4 shares performance

Nevertheless, new opportunities which telecom companies could explore are arising. One of the major opportunities is the liberalization and privatization of the postal market, a measure imposed by the European Commission for 2012. Despite this, market suffered from an increasing competitiveness of digital services. In the Portuguese market, CTT (the Portuguese postal company) has almost a monopolistic position in the postal market. Therefore, telecom companies may be interested in buying CTT and entering in this mature market with low levels of competition.

Furthermore, ZON did not enter in the public auction for the frequencies of fourth generation of mobile communication, LTE network, in December 2011. There were only three companies “competing” in the auction, TMN, Vodafone, and Optimus. This new generation will enable mobile operators to have better services in terms of high speed of Internet and higher quantity of data transferred on smartphones and tablets. Several tests are being done, since 2009, by mobile operators and the results show that it is possible to achieve high speed Internet between 100 Mbps and 150 Mbps, results that can easily compete with the fixed broadband.

### **Market Shares Evolution Analysis<sup>5</sup>**

In order to ease the process of market analysis, we should split the telecommunication industry in five different subsectors: fixed telephone; mobile telephone; fixed broadband; mobile broadband; and pay-TV<sup>6</sup>. Several companies are already operating on both markets; however there is only one company with a strong position in all of them, Portugal Telecom.

---

<sup>5</sup> Sources – ICP Anacom

<sup>6</sup> See appendix 5 for market shares evolution

Portugal Telecom is the major player in the telecommunication industry in Portugal, being the market leader in almost all services - mobile telephone (TMN), fixed telephone (MEO), fixed broadband (MEO) and mobile broadband (TMN/Sapo). It is only beaten by ZON in the pay-TV subsector. Still, ZON had a much more powerful position in this market some years ago - over 80% market share - but nowadays it has already lost almost 23% to its main competitor, PT.

On the other hand, PT had the monopolistic position in the fixed telephone subsector for several years and, at this point, ZON is increasing its market share, conquering customers from PT.

In terms of mobile telephone, PT is also the market leader through its sub-holding, TMN. Optimus, which belongs to Sonaecom, is occupying the third position on these services, after the international company Vodafone. ZON established a 5-year partnership, in 2008, with Vodafone, in order to explore the mobile phone sector, although it just has a very weak position in the market - nearly 0.5% of market share.

Concerning the distribution of fixed broadband, PT is the market leader, through Meo. Nevertheless, ZON is the main competitor reaching almost 35% of market share, against the 45% that PT holds.

Finally, mobile broadband has three main operators: TMN, Vodafone, and Optimus (Kanguru). In terms of market position, TMN is the market leader, with more than 40% of market share. However, in this subsector Optimus have been showing better performance than Vodafone, achieving a market share of almost 30%.

Rodrigo Costa knows that customers' demand changed a lot since ZON spun off. Thus, it is also crucial to analyze the demand evolution. Nowadays, customers are no longer looking to buy a simple service. New packages which aggregate three or more services are being more required. Namely, the *tripleplay* packages (pay-TV, fixed broadband and fixed phone), and the *multiplay* packages (pay-TV, mobile broadband, fixed broadband, fixed phone and mobile phone)<sup>7</sup>. Between 2009 and 2010, they have increased by 63.1% and 44.1% respectively, contrasting with the slowdown demand in the *doubleplay* and *simpleplay* packages.

Bundle Offers, integrating three or more services, are the newest tendency in this sector creating great opportunities for operators to increase profits and customer loyalty. The larger operators, with higher investment capacity, have already started exploring these new opportunities but experiences show that customers demand a really competitive integrated offer and not just a simple market expansion into new segments. Thus, the tie-up between these two companies seems promising by joining the best of both worlds, mobile and cable operators.

### **Opportunities in M&A**

Once the market and macroeconomic outlook was analyzed, Rodrigo Costa and its team focused on the possible opportunities that may arise from the merger. Initially, they decided to review the most recent M&A deals in this sector, in Europe, and the reasons why those companies decided to enter those M&A activities.

---

<sup>7</sup> See appendix 6 for packages demand

One of the main reasons for the M&A activities is the fixed to mobile convergence. Telecom companies are progressively aware that it is extremely important to offer a bundle of different services in the same package, or the strongest players will take them out of the market. Rodrigo Costa is completely aware that the merger with Sonaecom would enable the new company to provide all the services required by customers.

A second reason that leads to M&A activities in the telecom sector is the constant and costly investments which an operator has to do if it wants to keep its competitiveness in terms of high speed connection and in processing capacity. This is one of the main reasons why smaller players have extreme difficulties to keep operating in the telecom sector. In this issue, the merger between Sonaecom and ZON will certainly give the new company higher investment capacity and, more significantly, it would avoid double investments as, for example, the ones that both companies made in fiber network.

At present, in Europe, telecom sector presents low growth rates. This is mainly due to the fact that products are almost reaching maturity in its life cycle, showed by strong rivalry and a drop in the average revenue. Thus, through M&A activities, companies not only reduce the competition, achieving higher levels of profitability, but they also gain those aspects aforementioned.

### **Rationale of the Deal**

There are clear reasons to explain the rationale behind this possible merger. Both companies had redesigned their strategies in a way that seemed to be purposeful to become even more complementary in this new telecom sector.

Recently, ZON had the chance to become a mobile operator but it did not enter in the LTE auction. If it would have entered in the auction, surely an enormous investment in infrastructures would have to be made. However, it would allow ZON to become independent from Vodafone and discontinue its MVNO<sup>8</sup> agreement. On the other hand, it is also clear the disinterest of Sonaecom to keep investing in the fixed segment.

Thus, easily with their tie-up, the resulting company would have strengthened its positions in every business units in the sector. This tie-up would permit to extend its market penetration in the *multipleplay* market, as either party has a strong position in their core businesses. Furthermore, and thanks to the size of the new entity<sup>9</sup>, the investment capacity will be much higher and it will allow developing new opportunities that would be impossible if both companies keep operating separately.

### **Synergies**

For Rodrigo Costa it is clear that a consolidation between ZON and Sonaecom will create several new opportunities that would not be available to these companies operating independently. By exploiting these opportunities, the new company could gather better conditions to keep operating in this sector. These types of opportunities are called synergies – two companies functioning together can create more value than if they were functioning as standalone companies.

---

<sup>8</sup> MVNO - Mobile virtual network operator (MVNO) is a company that provides mobile phone services directly to their own customers but does not own key network assets.

<sup>9</sup> See Appendix 7 for Espírito Santo Research for Estimates to ZON + SNC P&L excluding synergies

Rodrigo Costa knows that cost reductions are the most reliable sources of synergy and those most recognized by the market to justify the merger. In fact, it is an internal issue that could be controlled. Savings in operating costs are the ones that could be estimated more accurately and usually, after the merger, have low deviations from the expectations. Furthermore, this type of synergies is known by its fast implementation process and perpetual income.

In this specific merger cost synergies between ZON and Sonaecom, could be achieved either by reducing OPEX (operating expenses) or by reducing CAPEX (capital expenditures).

OPEX is mainly constituted COGS (cost of goods sold) and direct costs of services rendered. With this tie-up it will be possible to substantially reduce the costs incurred in Internet and fixed voice segments. It would make no sense to keep operating with two independent wire lines. Also, on the mobile sector, the resulting company will have an opportunity to reduce costs. At present, ZON is offering mobile services, however it does not have the infrastructures required to be an operator. Therefore, it had to establish a MVNO with Vodafone, so that they could use its infrastructures. Additionally, the resulting company will be able to create a more effective communication with customers, since there will be more available income that could be used in marketing. Nevertheless, the total amount needed to be spent in advertisement will be less than the sum of its marketing expenses if the companies were operating independently.

In the telecom market, the network infrastructure requires high investments. The lack of investment capacity is one of the major factors that lead smaller operators to quit from this industry. Surely the resulting company will have a higher investment capacity. Furthermore, two investments will no longer be needed for the same infrastructures, as it occurred in the case of the fiber optic network. Nevertheless, one should not forget that the core business of these two companies requires different types of infrastructures; ZON is a wire line operator, while Sonaecom is a mobile operator. Although, it is still believed that some potential synergies may arise from this tie-up, more specifically in the fixed segment. Sonaecom will no longer have to invest in the fixed segment, leaving its fiber optic network to ZON, which will be used to complement ZON's networks. Thus, the existing Sonaecom customers will automatically become new customers of ZON.

Contrasting to cost synergies, revenue synergies are dependent on external issues to a company, thus it is harder to forecast and to control. In revenue synergies, competition plays a very important role. If this merger precedes, the competition, mainly PT, will strengthen its strategy to smooth the impact of this new and more powerful company, in its earning. Consequently, the resulting company will have to design a powerful strategy which will allow them to keep their customers (i.e. not losing them to its competitors) as well as attract new ones.

Revenue synergies in the merger between ZON and Sonaecom can be achieved by, firstly, a greater pricing power and, secondly, a combination of different functional strengths. The former is a consequence from the reduction in competition and an expectation from higher



market share that might arise from the merging process. The latter is the result of the combined market skills that both companies have in different areas of the telecom market.

### **Integration Costs**

The process of merging two companies also brings some extra costs that cannot be disregarded from opportunities created by the merger. Rodrigo Costa divided these costs into three different types of expenses. Firstly, when consolidating two publicly traded companies, there has to be taken into account the costs from legal firms. They are high but are required to secure the interest of the parties involved.

The second costs considered by ZON's team were related to employees who are going to be dismissed. Although it is a cost reduction in the long run, in the short run the payment of compensation will be required.

The last category of integration costs has to do with the necessity of creating a new identity for the new company, "Zonaecom". Different companies have different corporate cultures and a merger may damage employee moral within the company. So, when building a strong brand identity for "Zonaecom", it is mandatory to invest in internal marketing.

All in all, analysts<sup>10</sup> forecast say that if the deal goes forward, the combined entity will save 4% a year in CAPEX and 2% in OPEX and gain an extra 0.2% a year on the revenue synergies. The costs of integration would amount to 50 million euros - 10 million on the first year, 30 million on the second and 10 million on the last year of integration.

---

<sup>10</sup> Source – Espírito Santo Investment Bank Research for Estimates

Considering the tie-up will still be done in 2011, the estimated synergies are just expected to take an impact on the company earnings from 2012 onward.<sup>11</sup>

As Rodrigo Costa was expecting, it is certain that the merger would actually be a good solution for ZON to grow inorganically. However, he has to convince shareholders from either party, mainly ZON, that this deal will definitely add value to both companies. And now it is time to reflect on the terms of the merger agreement he should propose to his shareholders, in order to obtain their votes in favor of the merger.

The fact that Sonaecom managers are willing to lose some control on the new entity, gives him maneuverability to design a deal which could be accepted by both companies. Still, the proposal should be done as soon as possible because the integration process could be longer than what it is expected and, consequently, some possible synergies could be lost if the merger does not take place in the near future.

---

<sup>11</sup> See appendix 8 for WACC estimations

## **Teaching Objectives**

This case study is about a possible merger, which was never officially announced, between two real companies. The data used during the case is real while the conducted synergies in this case study were estimated. This case would fit best in courses as corporate finance or mergers and acquisitions. Students should understand the strong strategic benefits that the tie-up would bring for both party, and the future market position the new company will have. As well as the financial savings resulted from the exploitation of companies synergies.

## **Suggested Questions**

1. Should ZON try to merge with Sonaecom or would it be preferable to acquire a significant stake of Sonaecom? What should be the form of payment?
2. What would be the NPV of Synergies? Assume an execution risk of 10% and a terminal growth rate of 1%.
3. What could be a reasonable exchange ratio? Should ZON pay any premium to Sonaecom?
4. How will the new Shareholder structure become?

## **Merger vs Acquisition**

Sonae SGPS has a majority position in Sonaecom shareholder structure, owning more than 50% of Sonaecom shares. Thus it will be necessary an agreement between these two companies, if Ricardo Costa wants to proceed with this consolidation operation. Hence two main issues make us believe that the merger should be the best alternative. Firstly an

acquisition would obey ZON to search for finance, since it would represent a huge investment. Considering the actual economic crisis it would not be easy to find possible investor disposed to finance this operation. Secondly, any cash out from ZON would certainly reduce the possible synergies, or even erase them in total. Finally, Sonae SGPS would have to be available to abandon its operations in the telecom sector, which extremely unlikely to happen. For all these reasons, Ricardo Costa should propose a merger, using ZON shares as form of payment.

### **Synergies valuation**

In order to compute the NPV resulted from the synergies, it is necessary to compute the WACC for “Zonaecom”. It could be computed from the combination of the WACCs of Sonaecom, 8.853%, and ZON 8.076% weighted by their current market value (that, as of 7<sup>th</sup> December 2011 was) of €1.23 and €2.16, respectively, plus the 10% execution risk. According with this process “Zonaecom” WACC is 9.92285%. Thus, the sum of cash flows generated by synergies is €155.9602m. Finally, using the terminal growth rate of 1%, the terminal value of the new company will be €194.9177m. Summing up these values we achieve a NPV from synergies of 350.8779 million euros<sup>12</sup>.

### **Exchange Ratio**

The exchange ratio that could be used was computed through two different methodologies. Firstly, using the current market value (7<sup>th</sup> December 2011) and, secondly, using the

---

<sup>12</sup> See Appendix 1 for NPV estimations

average price of last six months<sup>13</sup>. The gap between these two values can be used on the debate around the regarding if ZON should pay any premium or not. Values out of this interval could be considered unfair, as there will be a company whose shareholders are going to lose some value from the exploitation of the synergies.

### **The New Shareholder Structure**

Assuming that both companies will agree in using the exchange ratio resulted from the valuation methodology that considers the current market price, the shareholder structure of the resulting company will be formed by 40% of former Sonaecom shareholders and 60% from ZON<sup>14</sup>. Thus, it should be emphasized that although Sonaecom will have lower control on Zonaecom, the two biggest shareholders will be the former Sonaecom shareholders, which could lead to complaints from ZON former shareholders.

### **Recent News**

More recently, in 26<sup>th</sup> December 2011, *Caixa Geral de Depósitos* and *Banco Espírito Santo* showed interest in changing the vote policy in ZON<sup>15</sup>. Now, there is a 10% limit on the right to vote (a shareholder with 10% of the company has the same power as a shareholder with 20%). Their proposal is to abolish this 10% limit of the right to vote per shareholder. If this new policy is approved, in annual general meeting in 30 January 2012, it is believed that Ms. Isabel dos Santos will be interested in buying a larger stake of ZON, which would probably ease the process of ZON's consolidation.

---

<sup>13</sup> See Appendix 2 for Exchange ratio estimations

<sup>14</sup> See Appendix 3 for the Zonaecom shareholder structure

<sup>15</sup> Sources: [http://www.jornaldenegocios.pt/home.php?template=SHOWNEWS\\_V2&id=527819](http://www.jornaldenegocios.pt/home.php?template=SHOWNEWS_V2&id=527819)

**A Work Project, presented as part of the requirements for the Award of a Master's  
Degree in Finance from Nova School of Business and Economics from Universidade  
Nova de Lisboa**

# **Merger between Zon Multimedia and Sonaecom: Revisiting the consolidation Scenario**

**Henrique Almeida, 347**

**Supervision of:  
Professor Paulo Soares Pinho**

**6<sup>th</sup> January 2012**

## **Revisiting the merger and acquisition scenario**

Several changes in the Portuguese telecommunication sector led Rodrigo Costa, CEO of Zon Multimedia (ZON), to revisit a possible merger with Sonaecom (SNC). This subject has been discussed since ZON spun off from Portugal Telecom (PT), in November 2007. In fact, ZON profits are being affected by the current Portuguese crisis, the increasingly intense competition of PT and the incapability of providing a complete and reliable package integrating all the services (mobile telephone, fixed telephone, mobile broadband, fixed broadband and pay-TV), demanded by customers.

Despite clear strategic benefits the merger would bring to both companies, its tie-up was never concluded, mainly due to the opposition of ZON's shareholders who are simultaneously in PT's shareholders structure. Rodrigo Costa knows that there are clear synergies that could be exploited if this tie-up goes forward and he believes that those synergies would create value for both companies' shareholders.

Firstly, this tie-up could bring significant reduction in expenses, as well as a small increase in revenues. Furthermore, the size of the resulting company will be considerably larger and will attain 3.5 million mobile subscribers and 3 million in the fixed segment. On the other hand, Portugal Telecom launched Meo, in May 2009, as its commercial telecommunications services. Since then, and through an aggressive marketing strategy, Meo has shown exponential penetration in the market, leading to an increasingly strong competition. PT has benefited from being one of the largest Portuguese companies, which allowed enormous investments in advertisement, in order to attract customers. Nowadays, this is what differentiates the companies in this sector, as there is not so much price

competition. It is also the reason why a customer prefers one company's services and over another.

Sonaecom has been interested in this possible merger for a long time and Paulo Azevedo, CEO of Sonae SGPS, Sonaecom's major shareholder, has already shown publicly interest in the merger. Furthermore, there were recent changes in ZON's shareholder structure and it is predictable that other changes will occur soon. Thus, Rodrigo Costa considers that this could be the right time to revisit the possible merger of these two companies.

### **Brief Description of the Companies**

#### **Zon Multimedia<sup>1</sup>**

PT Multimedia, now Zon Multimedia, was a fully owned subsidiary of Portugal Telecom. An unsuccessful attempt by Sonaecom to acquire PT, in 2007, via a hostile takeover, led to PT Multimedia to spin off from Portugal Telecom. This take-off was not achieved mainly due to the opposition of PT shareholders. Afterwards, the market regulator (ANACOM), forced the spin-off of PT's subsidiary, since it had almost a monopolistic position in the Portuguese telecommunication sector.

Thus, Zon Multimedia, ex- PT Multimedia, was born from the structural reorganization of Portugal Telecom in November 2007. Since then, the company has been led by Rodrigo Costa, a former member of PT's board of directors. Following the spin off, Rodrigo Costa tried to emphasize that ZON did not belong to Portugal Telecom any longer. Thus, some of his primary decisions had as main goal clarifying employees and customers that ZON was a

---

<sup>1</sup> See Appendix 1 for Financial information and shareholder structure



new company, with a new culture. On the first day after the spin-off, Rodrigo Costa ordered to remove PT's logo from its headquarters, becoming the company to be called only as Multimedia for some months.

Nowadays, its operations could be divided into three different business units: the pay-TV market, telecommunications and entertainment even though nowadays its core business is the *tripleplay* market, which integrates pay-TV, fixed telephone and fixed broadband in one service. Operating in a highly competitive market and with fast development in new technologies, ZON made huge investments in order to develop new technologies and improve its own infrastructure. It is the market leader in the pay-TV business and it is still growing in the fixed broadband and fixed telephone. ZON is also able to provide mobile services (telephone and broadband) complementing its offers in the telecommunication sector. In terms of fixed offers, ZON is extending increasingly in the corporate sector.

In 2010, ZON started its first activity in the international market, in Angola, with a partnership with Ms. Isabel dos Santos. Recently, in June 2011, it has also started operating in Mozambique. However, it is extremely exposed to the Portuguese market and, by now, internationalization is not a solution to solve the problems caused by the difficult Portuguese economic situation and changes in demand.

One of ZON's main goals is to keep the leading position in the pay-TV market and in innovative services on digital offers, with gradually more sophisticated and attractive features and with more contents in High Definition (HD). In January 2011, the company launched a new platform, called Iris, and in October released 10 new HD channels achieving the leadership position in the HD market, with a total of 36 channels. At the same

time, it has been developing its customer service and reinforcing its coverage in the private market. On the other hand, in the cinema market, it has been investing in new technologies, such as digital and 3D cinemas, making ZON an international reference in this sector.

In 2010, ZON invested 248.1 million euros, 28% of its total revenues, continuing the investment process started in 2008. However, it is expected that from 2011 onwards there will be significant reductions on CAPEX.

Despite high levels of investment in the economic year of 2010, the group approved to pay dividends of 0.16 euros per share, which totaled 49.5 million euros. *Caixa Geral de Depósitos* is its biggest shareholder (10.88% of total capital) followed by *Kento Holding* (10%), *Banco Português de Investimento* (7.56%), *Telefonica* (5.46%), *Banco Espírito Santo* (5%), *Joaquim Oliveira* (4.84%), *Joe Berardo* (4.34%) and *Ongoing* (3.29%).

ZON's shareholders position was never clear regarding this possible merger. One can think that ZON's position is mainly due to the fact that its biggest shareholders are the same ones as those of PT, its major competitor. Therefore, it is not easy to predict which position would be more valuable for them. On the one hand, the exploitation of possible synergies between ZON and Sonaecom can increase competition with PT, which could lead to the decrease of their profits. On the other hand, keeping PT without any severe competition means not getting the possible benefits from tie-up of ZON and Sonaecom.

At present, it is predictable that some changes in shareholder structure will occur in the short to medium run and it is believed that the rational position of these new shareholders would be in favor of the merger. To start with, it is believed that *Kento Holdings*, which bought a 10% stake at ZON, in the end of 2009, is favorable to a possible merger. Also,

*Cofina*, one of the biggest shareholders against the tie-up, exited from ZON's capital structure. And finally, according to the IMF and European Authorities, *Caixa Geral de Depósitos* will have to divest on the non-core subsidiaries. And, since it has an important position in PT's shareholder structure, probably it will quit from ZON as it makes no sense to keep its position on both companies.

### **Sonaecom (SNC)<sup>2</sup>**

Sonaecom, led by Ângelo Paupério, is the Sonae Telecommunications holding. It was founded in 1994 and its core business is the telecommunication sector, through Optimus, covering both corporate and residential customers in Portugal. Furthermore, it also operates in the Software and Systems Information (SSI) and in Media sectors.

Sonaecom has been disclosing increasing profitability and guarantees that it is progressing in all business units, reinforcing its market share in the mobile segments offering innovative solutions. At the same time, it has achieved a new level of efficient and rigorous management of costs and investments. Even in the current difficult economic situation Sonaecom has encouraging prospects for the future, assuming that it is prepared to face the challenges and grab the opportunities that might appear in the market.

Its main goal is to be the best group in the Portuguese integrated telecommunication sector, with a strategy that goes through continuous investments in a network of advanced technology offering the best fixed and mobile services. Thus, in 2010, its activities were reorganized, devoting special attention to mobile and fixed services.

---

<sup>2</sup> See Appendix 2 for Financial information and shareholder structure

Optimus, led by Miguel Almeida, represents 90% of Sonaecom business volume. It concentrates the communication activity and covers all the market segments – residential, private, mass business, corporate, and wholesale – and all business areas – mobile and fixed, aiming to provide integrated solutions in voice, broadband, TV and data, through mobile or fixed terminals.

The mobile market is the core of Optimus, but the fixed market is assuming an increasingly important and complementary role. In the latter, the strategy is mainly concentrated in the corporate segment, while the residential segment is becoming more and more residual. Consequently, in 2010, Optimus stopped investing in its own fiber networking and looked for alternatives that would allow them to keep expanding. This new strategy included a partnership with Vodafone, which allowed Optimus to use Vodafone fiber optic network to duplicate its coverage in Oporto and in Lisbon.

On the other hand, in the Software and Systems Information (SSI) sector which aggregates numerous companies renowned in the IT sector, Sonaecom is investing in the consolidation of WeDo, assuring the development in areas as fraud prevention and business assurance. In the media sector, the group will keep its daily newspaper, *Público* both online and paper versions, as well as *Miau.pt*, the online auction website.

Sonaecom is listed in the PSI-20 having a constant shareholder structure over the past decade. *Sonae SGPS* is the major shareholder, holding more than 53% of the total shares, around 21% of the shares are free float, followed by *France Telecom* (20%) and *Banco Comercial Português* (3.41%).

### **Portugal Telecom (PTC) <sup>3</sup>**

The growth of Portugal Telecom is one of the factors that most worries Rodrigo Costa. With PT Multimedia's spin-off, Portugal Telecom launched a new brand, called Meo, which would compete with ZON in the pay-TV market, as well as in the *tripleplay* and *multipleplay* offers.

Firstly, we have to keep in mind that PT is one of the biggest Portuguese companies. Its investment capacity, in infrastructures and in marketing, is far higher than its competitors. One of the most relevant consequences of Portugal Telecom's size is the fact that a few years ago, PT had not had any offer in the pay-TV market, and only in three years it has achieved more than 30% of market share in this business unit. This allowed it to drive gains in the fixed broadband and reverse the negative trend in the fixed telephone.

In 2010, there was a fierce price competition between ZON and Meo, which led to consecutive decreases in the price for telecom services. Nowadays, the factors that drive customers to choose operator are the perception that each customer has from the companies. For instance, Meo has a clear advantage relatively to the other operators, since its communication strategy has been a great success. Notwithstanding, one cannot compare the expenses incurred by Meo in advertisement with the remaining operators.

Now, Meo has a clear goal of keeping its market leadership or achieve it in the business units that it does not at present. Through continuous investments in fixed and mobile infrastructures, PT intends to keep exploiting the synergies between them in order to provide even better integrated services.

---

<sup>3</sup> Appendix 3 for Key Performance Indicators (KPI)

## **Macroeconomic Outlook**

With the current economic situation in Portugal, the changes in demand by customers and the exponential growth of Portugal Telecom, Rodrigo Costa considers that both companies should revisit the M&A scenario.

Initially, the Portuguese macroeconomic outlook has been affecting negatively the stock market performance. Both companies have been penalized since the beginning of 2008: Sonaecom performance stands at -46.6%, ZON at -76.1% and the main Portuguese Index (PSI-20) at -49%. In September 2009, rumors of a possible merger of these two companies led companies to gain more than 3%, which could be interpreted that the merger could be well accepted by the market in general.<sup>4</sup>

Another concern resulting from the actual economic situation is the changes in credit markets, specifically costs and also availability of credit. These changes not only affect companies when they are seeking for new credits, but also for their shareholders, which have been using their shares as collateral in credit lines. Nowadays, these shareholders have to use additional guarantees as collateral since the shares have lost a significant value.

Regarding the Portuguese economy, the greatest concern of Rodrigo Costa is the fact that his company is tremendously exposed to the Portuguese market. Thus, it is crucial to find new methods to keep and strengthen its positions in the market. Domestic consumption is expected to decrease in 2012, and it will have a negative impact in ZON's revenues. This puts ZON under pressure, forcing them to seek different paths to bear their operating performance.

---

<sup>4</sup> See appendix 4 shares performance

Nevertheless, new opportunities which telecom companies could explore are arising. One of the major opportunities is the liberalization and privatization of the postal market, a measure imposed by the European Commission for 2012. Despite this, market suffered from an increasing competitiveness of digital services. In the Portuguese market, CTT (the Portuguese postal company) has almost a monopolistic position in the postal market. Therefore, telecom companies may be interested in buying CTT and entering in this mature market with low levels of competition.

Furthermore, ZON did not enter in the public auction for the frequencies of fourth generation of mobile communication, LTE network, in December 2011. There were only three companies “competing” in the auction, TMN, Vodafone, and Optimus. This new generation will enable mobile operators to have better services in terms of high speed of Internet and higher quantity of data transferred on smartphones and tablets. Several tests are being done, since 2009, by mobile operators and the results show that it is possible to achieve high speed Internet between 100 Mbps and 150 Mbps, results that can easily compete with the fixed broadband.

### **Market Shares Evolution Analysis<sup>5</sup>**

In order to ease the process of market analysis, we should split the telecommunication industry in five different subsectors: fixed telephone; mobile telephone; fixed broadband; mobile broadband; and pay-TV<sup>6</sup>. Several companies are already operating on both markets; however there is only one company with a strong position in all of them, Portugal Telecom.

---

<sup>5</sup> Sources – ICP Anacom

<sup>6</sup> See appendix 5 for market shares evolution

Portugal Telecom is the major player in the telecommunication industry in Portugal, being the market leader in almost all services - mobile telephone (TMN), fixed telephone (MEO), fixed broadband (MEO) and mobile broadband (TMN/Sapo). It is only beaten by ZON in the pay-TV subsector. Still, ZON had a much more powerful position in this market some years ago - over 80% market share - but nowadays it has already lost almost 23% to its main competitor, PT.

On the other hand, PT had the monopolistic position in the fixed telephone subsector for several years and, at this point, ZON is increasing its market share, conquering customers from PT.

In terms of mobile telephone, PT is also the market leader through its sub-holding, TMN. Optimus, which belongs to Sonaecom, is occupying the third position on these services, after the international company Vodafone. ZON established a 5-year partnership, in 2008, with Vodafone, in order to explore the mobile phone sector, although it just has a very weak position in the market - nearly 0.5% of market share.

Concerning the distribution of fixed broadband, PT is the market leader, through Meo. Nevertheless, ZON is the main competitor reaching almost 35% of market share, against the 45% that PT holds.

Finally, mobile broadband has three main operators: TMN, Vodafone, and Optimus (Kanguru). In terms of market position, TMN is the market leader, with more than 40% of market share. However, in this subsector Optimus have been showing better performance than Vodafone, achieving a market share of almost 30%.



Rodrigo Costa knows that customers' demand changed a lot since ZON spun off. Thus, it is also crucial to analyze the demand evolution. Nowadays, customers are no longer looking to buy a simple service. New packages which aggregate three or more services are being more required. Namely, the *tripleplay* packages (pay-TV, fixed broadband and fixed phone), and the *multiplay* packages (pay-TV, mobile broadband, fixed broadband, fixed phone and mobile phone)<sup>7</sup>. Between 2009 and 2010, they have increased by 63.1% and 44.1% respectively, contrasting with the slowdown demand in the *doubleplay* and *simpleplay* packages.

Bundle Offers, integrating three or more services, are the newest tendency in this sector creating great opportunities for operators to increase profits and customer loyalty. The larger operators, with higher investment capacity, have already started exploring these new opportunities but experiences show that customers demand a really competitive integrated offer and not just a simple market expansion into new segments. Thus, the tie-up between these two companies seems promising by joining the best of both worlds, mobile and cable operators.

### **Opportunities in M&A**

Once the market and macroeconomic outlook was analyzed, Rodrigo Costa and its team focused on the possible opportunities that may arise from the merger. Initially, they decided to review the most recent M&A deals in this sector, in Europe, and the reasons why those companies decided to enter those M&A activities.

---

<sup>7</sup> See appendix 6 for packages demand

One of the main reasons for the M&A activities is the fixed to mobile convergence. Telecom companies are progressively aware that it is extremely important to offer a bundle of different services in the same package, or the strongest players will take them out of the market. Rodrigo Costa is completely aware that the merger with Sonaecom would enable the new company to provide all the services required by customers.

A second reason that leads to M&A activities in the telecom sector is the constant and costly investments which an operator has to do if it wants to keep its competitiveness in terms of high speed connection and in processing capacity. This is one of the main reasons why smaller players have extreme difficulties to keep operating in the telecom sector. In this issue, the merger between Sonaecom and ZON will certainly give the new company higher investment capacity and, more significantly, it would avoid double investments as, for example, the ones that both companies made in fiber network.

At present, in Europe, telecom sector presents low growth rates. This is mainly due to the fact that products are almost reaching maturity in its life cycle, showed by strong rivalry and a drop in the average revenue. Thus, through M&A activities, companies not only reduce the competition, achieving higher levels of profitability, but they also gain those aspects aforementioned.

### **Rationale of the Deal**

There are clear reasons to explain the rationale behind this possible merger. Both companies had redesigned their strategies in a way that seemed to be purposeful to become even more complementary in this new telecom sector.

Recently, ZON had the chance to become a mobile operator but it did not enter in the LTE auction. If it would have entered in the auction, surely an enormous investment in infrastructures would have to be made. However, it would allow ZON to become independent from Vodafone and discontinue its MVNO<sup>8</sup> agreement. On the other hand, it is also clear the disinterest of Sonaecom to keep investing in the fixed segment.

Thus, easily with their tie-up, the resulting company would have strengthened its positions in every business units in the sector. This tie-up would permit to extend its market penetration in the *multipleplay* market, as either party has a strong position in their core businesses. Furthermore, and thanks to the size of the new entity<sup>9</sup>, the investment capacity will be much higher and it will allow developing new opportunities that would be impossible if both companies keep operating separately.

### **Synergies**

For Rodrigo Costa it is clear that a consolidation between ZON and Sonaecom will create several new opportunities that would not be available to these companies operating independently. By exploiting these opportunities, the new company could gather better conditions to keep operating in this sector. These types of opportunities are called synergies – two companies functioning together can create more value than if they were functioning as standalone companies.

---

<sup>8</sup> MVNO - Mobile virtual network operator (MVNO) is a company that provides mobile phone services directly to their own customers but does not own key network assets.

<sup>9</sup> See Appendix 7 for Espírito Santo Research for Estimates to ZON + SNC P&L excluding synergies

Rodrigo Costa knows that cost reductions are the most reliable sources of synergy and those most recognized by the market to justify the merger. In fact, it is an internal issue that could be controlled. Savings in operating costs are the ones that could be estimated more accurately and usually, after the merger, have low deviations from the expectations. Furthermore, this type of synergies is known by its fast implementation process and perpetual income.

In this specific merger cost synergies between ZON and Sonaecom, could be achieved either by reducing OPEX (operating expenses) or by reducing CAPEX (capital expenditures).

OPEX is mainly constituted COGS (cost of goods sold) and direct costs of services rendered. With this tie-up it will be possible to substantially reduce the costs incurred in Internet and fixed voice segments. It would make no sense to keep operating with two independent wire lines. Also, on the mobile sector, the resulting company will have an opportunity to reduce costs. At present, ZON is offering mobile services, however it does not have the infrastructures required to be an operator. Therefore, it had to establish a MVNO with Vodafone, so that they could use its infrastructures. Additionally, the resulting company will be able to create a more effective communication with customers, since there will be more available income that could be used in marketing. Nevertheless, the total amount needed to be spent in advertisement will be less than the sum of its marketing expenses if the companies were operating independently.

In the telecom market, the network infrastructure requires high investments. The lack of investment capacity is one of the major factors that lead smaller operators to quit from this industry. Surely the resulting company will have a higher investment capacity. Furthermore, two investments will no longer be needed for the same infrastructures, as it occurred in the case of the fiber optic network. Nevertheless, one should not forget that the core business of these two companies requires different types of infrastructures; ZON is a wire line operator, while Sonaecom is a mobile operator. Although, it is still believed that some potential synergies may arise from this tie-up, more specifically in the fixed segment. Sonaecom will no longer have to invest in the fixed segment, leaving its fiber optic network to ZON, which will be used to complement ZON's networks. Thus, the existing Sonaecom customers will automatically become new customers of ZON.

Contrasting to cost synergies, revenue synergies are dependent on external issues to a company, thus it is harder to forecast and to control. In revenue synergies, competition plays a very important role. If this merger precedes, the competition, mainly PT, will strengthen its strategy to smooth the impact of this new and more powerful company, in its earning. Consequently, the resulting company will have to design a powerful strategy which will allow them to keep their customers (i.e. not losing them to its competitors) as well as attract new ones.

Revenue synergies in the merger between ZON and Sonaecom can be achieved by, firstly, a greater pricing power and, secondly, a combination of different functional strengths. The former is a consequence from the reduction in competition and an expectation from higher

market share that might arise from the merging process. The latter is the result of the combined market skills that both companies have in different areas of the telecom market.

### **Integration Costs**

The process of merging two companies also brings some extra costs that cannot be disregarded from opportunities created by the merger. Rodrigo Costa divided these costs into three different types of expenses. Firstly, when consolidating two publicly traded companies, there has to be taken into account the costs from legal firms. They are high but are required to secure the interest of the parties involved.

The second costs considered by ZON's team were related to employees who are going to be dismissed. Although it is a cost reduction in the long run, in the short run the payment of compensation will be required.

The last category of integration costs has to do with the necessity of creating a new identity for the new company, "Zonaecom". Different companies have different corporate cultures and a merger may damage employee moral within the company. So, when building a strong brand identity for "Zonaecom", it is mandatory to invest in internal marketing.

All in all, analysts<sup>10</sup> forecast say that if the deal goes forward, the combined entity will save 4% a year in CAPEX and 2% in OPEX and gain an extra 0.2% a year on the revenue synergies. The costs of integration would amount to 50 million euros - 10 million on the first year, 30 million on the second and 10 million on the last year of integration.

---

<sup>10</sup> Source – Espírito Santo Investment Bank Research for Estimates

Considering the tie-up will still be done in 2011, the estimated synergies are just expected to take an impact on the company earnings from 2012 onward.<sup>11</sup>

As Rodrigo Costa was expecting, it is certain that the merger would actually be a good solution for ZON to grow inorganically. However, he has to convince shareholders from either party, mainly ZON, that this deal will definitely add value to both companies. And now it is time to reflect on the terms of the merger agreement he should propose to his shareholders, in order to obtain their votes in favor of the merger.

The fact that Sonaecom managers are willing to lose some control on the new entity, gives him maneuverability to design a deal which could be accepted by both companies. Still, the proposal should be done as soon as possible because the integration process could be longer than what it is expected and, consequently, some possible synergies could be lost if the merger does not take place in the near future.

---

<sup>11</sup> See appendix 8 for WACC estimations

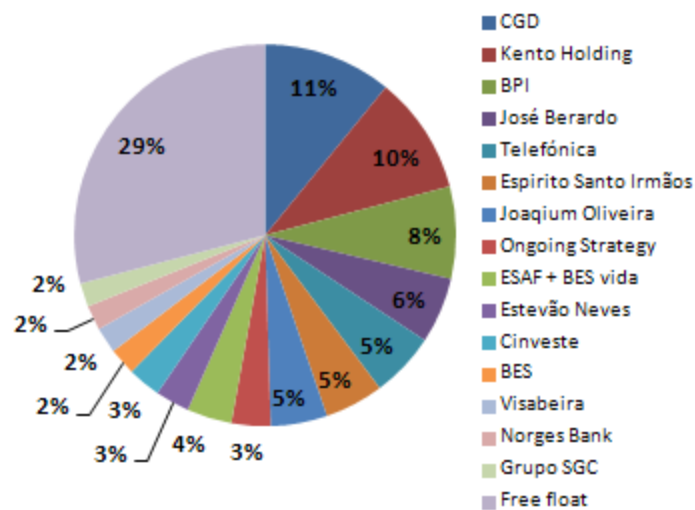
## Appendix 1<sup>12</sup> - ZON Financial Information

Operational Highlights ('000)	3Q10	4Q10	1Q11	2Q11	3Q11
Homes Passed	3166	3191	3207	3223	3151
Triple Play Costumers	603	642	666	678	689
Basic Subscribers	1573	1572	1554	1553	1554
Broadband	666	690	705	715	725
Voice	732	778	807	827	844
Mobile Phone	105	108	115	118	133
RGUs	3077	3147	3181	3213	3257
Cinema Tickets Sold	2670	2242	2016	2016	2372

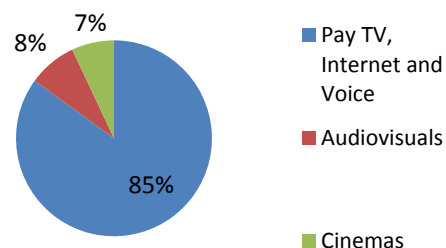
  

Financial Highlights (Millions €)					
Operating Revenues	221,6	221,1	214,1	211,5	213,7
EBITDA	79,5	79,3	79,5	78,5	79,6
Consolidated Net Income	8,6	3,9	10,2	9,2	9,1
CAPEX	59,4	78,5	38,8	35,5	35,1
EBITDA minus CAPEX	23,3	-5,2	40,7	43,1	44,5
Net Financial Debt	632,6	639,7	641,7	706,8	668,3

### Zon Multimedia Shareholder Structure



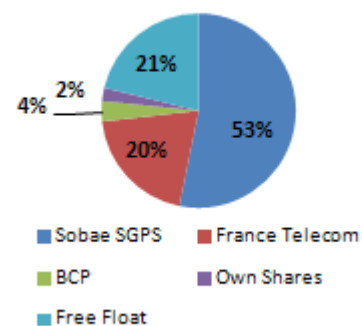
### Revenue Breakdown



## Appendix 2<sup>13</sup> - Sonaecom Financial Information

Operational Highlights ('000)	3Q10	4Q10	1Q11	2Q11	3Q11
Customers ('000)	3,541	3,604	3,606	3,586	3,639
Data as % Service Revenues	30.3%	32.4%	31.2%	32.8%	33.0%
ARPU <sup>14</sup> (euros)	13.9	13.3	12.6	13.0	13.5
Total Accesses	436,06	417,066	399,011	388,915	383,568
Average Revenue per Access (Retail)	23.8	24.2	24.1	23.8	22.5
Nr employees	2,07	2,057	2,074	2,066	2,054

### Sonaecom Shareholder Structure



<sup>12</sup> Source: Company Data

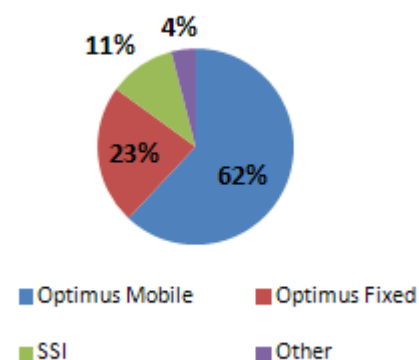
<sup>13</sup> Source: Company Data

<sup>14</sup> ARPU – Average revenue per user



Financial Highlights (Millions €)					
Turnover	233,8	236,6	215,8	209,6	224,9
EBITDA	49,5	45	50	56,5	57,5
EBITDA Margin	0,212	0,19	0,238	0,27	0,256
EBIT	18,1	13,7	19,7	24,9	25,7
OPER CAPEX	31.5	43.4	18.1	37.5	23.0
EBITDA - OPER CAPEX	18.0	1.6	31.9	19.0	34.5
FCF	3.8	1.1	2.6	9.3	16.7
Total Assets	1838	1862	1853	1836	1910
S/holder Funds	964	975	988	989	1015
Total Liabilities	874	887	866	846	895

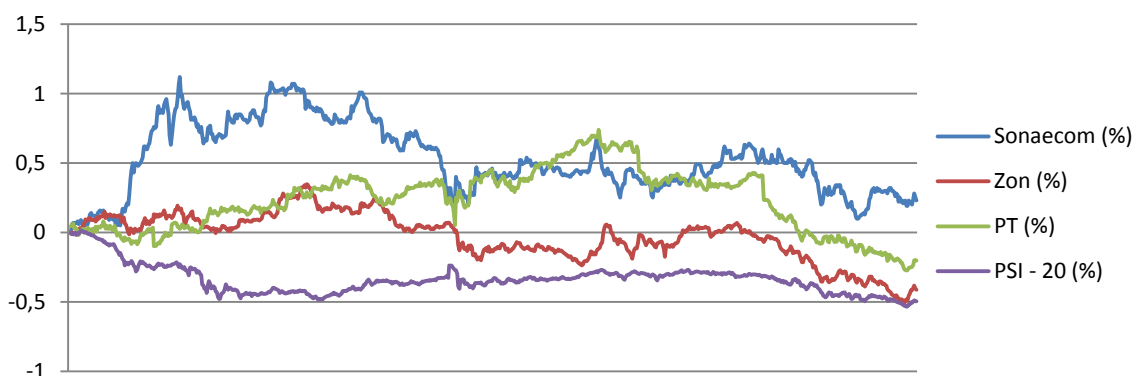
Revenues Breakdown



### Appendix 3 – Portugal Telecom KPI's<sup>15</sup>

Euro million	3Q10	4Q10	1Q11	2Q11	3Q11
Operating revenues	952	950	871	1,798	1,747
Operating costs	570	587	514	1,155	1,093
EBITDA	382	362	357	642	654
Income from operations	164	168	149	260	290
Net income	5,353	54	130	98	106
Capex	181	305	122	296	286
Capex as % of revenues	19.1%	32.1%	14.0%	16.5%	16.4%
Operating cash flow	227	-5	315	209	369
Free cash flow	4,63	834	453	-137	181
EBITDA margin	40.1%	38.2%	41.0%	35.7%	37.4%

### Appendix 4<sup>16</sup> – Shares Performance – 3 year Historical Stock Prices



<sup>15</sup> Source: Company Data

<sup>16</sup> Sources: Bloomberg and Yahoo! Finance

## Appendix 5 - Market Shares Evolution

5.1 - Pay-TV<sup>17</sup> – Number of Subscribers

Company	2009	2010	2011
ZON	64,4%	57,9%	54,9%
PT	23,0%	29,9%	33,2%
Cabovisão	10,2%	9,4%	8,8%
Sonaecom	1,0%	1,1%	1,2%
AR Telecom	0,9%	0,9%	-
Vodafone	0,3%	0,7%	0,1%

5.2 - Fixed Telephone<sup>18</sup> – Number of Subscribers

Company	2010	2011
PT	54,4%	53,4%
ZON	18,6%	20,1%
Sonaecom	15,0%	14,6%
Cabovisão	7,0%	6,9%

5.3 – Fixed Broadband<sup>19</sup> – Number of Subscribers

Company	2009	2010	2011
PT	44,5%	47,4	46,8%
ZON	32,2%	32,3%	33,0%
Cabovisão	8,0%	7,8%	7,3%
Sonaecom	9,2%	7,2%	5,6%

5.4 - Mobile Telephone<sup>20</sup> - Number of Subscribers

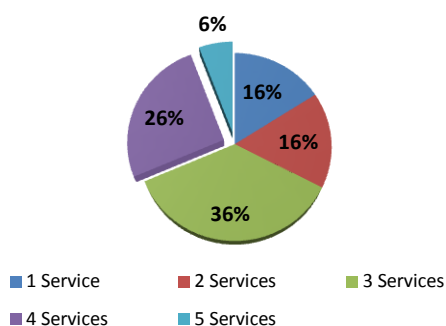
Company	2011
TMN	43,7%
Vodafone	39,1%
Optimus	15,7%

5.5- Mobile Broadband<sup>21</sup> - Number of Subscribers

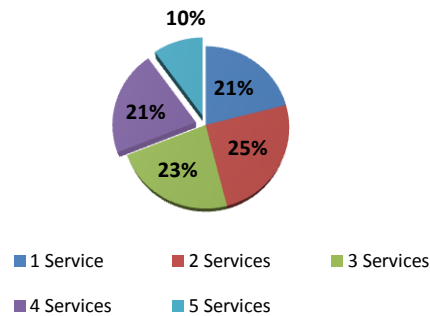
Company	2010	2011	Variation
TMN	50,8%	45%	-5,8%
Optimus	26,7%	29,1%	2,4%
Vodafone	20,2%	22,3%	2,1%

## Appendix 6<sup>22</sup>

Percentage of packages used by Companies



Percentage of packages used by individuals



<sup>17</sup> Source: ICP-Anacom - "Informação estatística do serviço de televisão por subscrição", 3<sup>rd</sup> Quarter 2011

<sup>18</sup> Source: ICP-Anacom - "Informação estatística do serviço telefone fixo", 2<sup>nd</sup> Quarter 2011

<sup>19</sup> Source: ICP-Anacom - "Informação estatística do serviço acesso à Internet", 3<sup>rd</sup> Quarter 2011

<sup>20</sup> Source: ICP-Anacom - "Serviços moveis – Informação estatística", 3<sup>rd</sup> Quarter 2011

<sup>21</sup> Source: ICP-Anacom - "Serviços moveis – Informação estatística", 3<sup>rd</sup> Quarter 2011

<sup>22</sup> Source: ICP-Anacom - "Situação das Comunicações", 2010

## Appendix 7<sup>23</sup> - ZON + SNC without synergies

Combined P&L (Eur m)	2011E	2012E	2013E	2014E	2015E	2016E	2017E	2018E	2019E	2020E
Revenue (ZON + SNC)	1689	1631	1639	1665	1698	1733	1766	1799	1832	1865
%	-	3,43%	-0,49%	-1,59%	-1,98%	-2,06%	-1,90%	-1,87%	-1,83%	-1,80%
Cash costs	1182	1112	1106	1113	1129	1146	1163	1182	1201	1220
%	-	5,92%	0,54%	-0,63%	-1,44%	-1,51%	-1,48%	-1,63%	-1,61%	-1,58%
EBITDA	507	519	533	552	569	587	603	617	631	645
%	-	2,37%	2,70%	3,56%	3,08%	3,16%	2,73%	2,32%	2,27%	2,22%
Combined CAPEX	448	342	310	356	349	344	350	356	364	367

## Appendix 8<sup>24</sup>

	Zon Multimedia	Sonaecom
Number of Shares Outstanding	309096830	366945875
Stock Price (December, 7)	2,16	1,23
Avg Stock Price (last 6 months)	2,545207792	1,320878536
Market Cap. (MM)	667,6491528	451,3434263
Avg Market Cap. (Last 6 months)	786,7156601	484,6909303
Net Debt	813	429,5
Enterprise Value	1480,649153	880,8434263
Capital Structure		
E/EV	0,450916513	0,512399154
D/EV	0,549083487	0,487600846
Rf (10 year german bond)	5,5%	5,5%
Market risk premium	6,0%	6,0%
Beta <sup>25</sup>	1,066776864	1,23630217
K <sub>e</sub> <sup>26</sup> (cost of equity)	11,9%	12,9%
K <sub>d</sub> <sup>27</sup> (cost of debt)	7,0%	6,5%
Tax rate	29,5%	29,5%
WACC <sup>28</sup>	0,080759317	0,088535073

<sup>23</sup> Source: Espírito Santo Investment Bank Research for Estimates

<sup>24</sup> Sources: Companies Data and Bloomberg

<sup>25</sup> Beta was computed following the three steps:

1. Collected unlevered the betas of comparable European companies;
2. Computed an average of the obtained unlevered betas
3. Leveraged the beta according to each company capital structure, using market values from 7<sup>th</sup> December 2011

<sup>26</sup> Used CAPM model:  $K_e = R_f + \beta \times \text{market premium}$

<sup>27</sup> According to Damodaran :  $K_d = R_f + \text{Company risk premium}$

The company risk premium was computed based on the stock prices standard deviation

<sup>28</sup> WACC – Weighted average cost of capital:  $WACC = \frac{D}{EV} \times K_d \times (1 - T) + \frac{E}{EV} \times K_e$

## **Teaching Objectives**

This case study is about a possible merger, which was never officially announced, between two real companies. The data used during the case is real while the conducted synergies in this case study were estimated. This case would fit best in courses as corporate finance or mergers and acquisitions. Students should understand the strong strategic benefits that the tie-up would bring for both party, and the future market position the new company will have. As well as the financial savings resulted from the exploitation of companies synergies.

## **Suggested Questions**

1. Should ZON try to merge with Sonaecom or would it be preferable to acquire a significant stake of Sonaecom? What should be the form of payment?
2. What would be the NPV of Synergies? Assume an execution risk of 10% and a terminal growth rate of 1%.
3. What could be a reasonable exchange ratio? Should ZON pay any premium to Sonaecom?
4. How will the new Shareholder structure become?

## **Merger vs Acquisition**

Sonae SGPS has a majority position in Sonaecom shareholder structure, owning more than 50% of Sonaecom shares. Thus it will be necessary an agreement between these two companies, if Ricardo Costa wants to proceed with this consolidation operation. Hence two main issues make us believe that the merger should be the best alternative. Firstly an

acquisition would obey ZON to search for finance, since it would represent a huge investment. Considering the actual economic crisis it would not be easy to find possible investor disposed to finance this operation. Secondly, any cash out from ZON would certainly reduce the possible synergies, or even erase them in total. Finally, Sonae SGPS would have to be available to abandon its operations in the telecom sector, which extremely unlikely to happen. For all these reasons, Ricardo Costa should propose a merger, using ZON shares as form of payment.

### **Synergies valuation**

In order to compute the NPV resulted from the synergies, it is necessary to compute the WACC for “Zonaecom”. It could be computed from the combination of the WACCs of Sonaecom, 8.853%, and ZON 8.076% weighted by their current market value (that, as of 7<sup>th</sup> December 2011 was) of €1.23 and €2.16, respectively, plus the 10% execution risk. According with this process “Zonaecom” WACC is 9.92285%. Thus, the sum of cash flows generated by synergies is €155.9602m. Finally, using the terminal growth rate of 1%, the terminal value of the new company will be €194.9177m. Summing up these values we achieve a NPV from synergies of 350.8779 million euros<sup>29</sup>.

### **Exchange Ratio**

The exchange ratio that could be used was computed through two different methodologies. Firstly, using the current market value (7<sup>th</sup> December 2011) and, secondly, using the

---

<sup>29</sup> See Appendix 1 for NPV estimations

average price of last six months<sup>30</sup>. The gap between these two values can be used on the debate around the regarding if ZON should pay any premium or not. Values out of this interval could be considered unfair, as there will be a company whose shareholders are going to lose some value from the exploitation of the synergies.

### **The New Shareholder Structure**

Assuming that both companies will agree in using the exchange ratio resulted from the valuation methodology that considers the current market price, the shareholder structure of the resulting company will be formed by 40% of former Sonaecom shareholders and 60% from ZON<sup>31</sup>. Thus, it should be emphasized that although Sonaecom will have lower control on Zonaecom, the two biggest shareholders will be the former Sonaecom shareholders, which could lead to complaints from ZON former shareholders.

### **Recent News**

More recently, in 26<sup>th</sup> December 2011, *Caixa Geral de Depósitos* and *Banco Espírito Santo* showed interest in changing the vote policy in ZON<sup>32</sup>. Now, there is a 10% limit on the right to vote (a shareholder with 10% of the company has the same power as a shareholder with 20%). Their proposal is to abolish this 10% limit of the right to vote per shareholder. If this new policy is approved, in annual general meeting in 30 January 2012, it is believed that Ms. Isabel dos Santos will be interested in buying a larger stake of ZON, which would probably ease the process of ZON's consolidation.

---

<sup>30</sup> See Appendix 2 for Exchange ratio estimations

<sup>31</sup> See Appendix 3 for the Zonaecom shareholder structure

<sup>32</sup> Sources: [http://www.jornaldenegocios.pt/home.php?template=SHOWNEWS\\_V2&id=527819](http://www.jornaldenegocios.pt/home.php?template=SHOWNEWS_V2&id=527819)

## Appendix 1 - ZON + Sonaecom: Potential Synergies

Combined P&L (Eur M)	2011E	2012E	2013E	2014E	2015E	2016E	2017E	2018E	2019E	2020E
Revenue (ZON + SNC)	1689	1631	1639	1665	1698	1733	1766	1799	1832	1865
%		3,43%	-0,49%	-1,59%	-1,98%	-2,06%	-1,90%	-1,87%	-1,83%	-1,80%
Cash costs	1182	1112	1106	1113	1129	1146	1163	1182	1201	1220
%		5,92%	0,54%	-0,63%	-1,44%	-1,51%	-1,48%	-1,63%	-1,61%	-1,58%
EBITDA	507	519	533	552	569	587	603	617	631	645
%		-2,37%	-2,70%	-3,56%	-3,08%	-3,16%	-2,73%	-2,32%	-2,27%	-2,22%
Revenue Synergy %	0	0,20%	0,20%	0,20%	0,20%	0,20%	0,20%	0,20%	0,20%	0,20%
Revenue Synergy (Eur)	0	3,262	3,278	3,33	3,396	3,466	3,532	3,598	3,664	3,73
Opex Saving %	0%	2%	2%	2%	2%	2%	2%	2%	2%	2%
Opex Saving (Eur)	0	22,24	22,12	22,26	22,58	22,92	23,26	23,64	24,02	24,4
Integration Costs	10	30	10	0	0	0	0	0	0	0
Combined CAPEX	448	342	310	356	349	344	350	356	364	367
CAPEX Savings %	0%	4%	4%	4%	4%	4%	4%	4%	4%	4 %
CAPEX Savings (Eur)	0	13,68	12,4	14,24	13,96	13,76	14	14,24	14,56	14,68
Total Operational Gross Synergies	-10	-4,498	15,398	25,59	25,976	26,386	26,792	27,238	27,684	28,13
Tax Rate	29,5%	29,5%	29,5%	29,5%	29,5%	29,5%	29,5%	29,5%	29,5%	29,5%
Taxes	0	0	4,54241	7,54905	7,66292	7,78387	7,90364	8,03521	8,16678	8,29835
Total Operational Net Synergies	-10	-4,498	10,85559	18,04095	18,31308	18,60213	18,88836	19,20279	19,51722	19,83165
Total Synergies	-10	9,182	23,25559	32,28095	32,27308	32,36213	32,88836	33,44279	34,07722	34,51165
Cash Flow	-10	8,406229	19,49195	24,77069	22,67233	20,81406	19,36537	18,02811	16,81805	15,59341
Sum of Cash Flows	155,9602									
Terminal Value	194,9177									
NPV of Synergies	350,8779									

## Appendix 2 – Exchange Ratio

	Current Stock Price			Average 6 months		
	Sonaecom	ZON	Zonaecom	Sonaecom	ZON	Zonaecom
Cur. market cap	451,34	667,65	1118,99	484,69	786,72	1271,41
Relative weight (Exchange Ratio)	0,403348007	0,596652	1,00	0,381224176	0,618775824	1,00
Synergies impact	141,5258964	209,352	350,8778872	133,7631336	217,1147536	350,8778872
New Market Value	592,87	877,00	1469,87	618,45	1003,83	1622,28
Upside from current market value	0,313565875	0,313566	0,313565875	0,275976143	0,275976143	0,275976143

### Appendix 3 - New Shareholder Structure *queres meter titulo no grafico?*

	<b>Zonaecom</b>
<b>Sonae SGPS</b>	0,214581
<b>France Telecom</b>	0,08067
<b>BCP</b>	0,013714
<b>Own Shares</b>	0,008874
<b>CGD</b>	0,065035
<b>Kento Holding</b>	0,059665
<b>BPI</b>	0,046539
<b>José Berardo</b>	0,033413
<b>Telefónica</b>	0,032816
<b>Espirito Santo Irmãos</b>	0,029833
<b>Joaquim Oliveira</b>	0,028639
<b>Ongoing Strategy</b>	0,01969
<b>ESAF + BES vida</b>	0,022673
<b>Estevão Neves</b>	0,017303
<b>Cinveste</b>	0,016706
<b>BES</b>	0,013723
<b>Visabeira</b>	0,013126
<b>Norges Bank</b>	0,01253
<b>Grupo SGC</b>	0,011933
<b>Free float</b>	0,259136
<b>TOTAL</b>	1,000000

